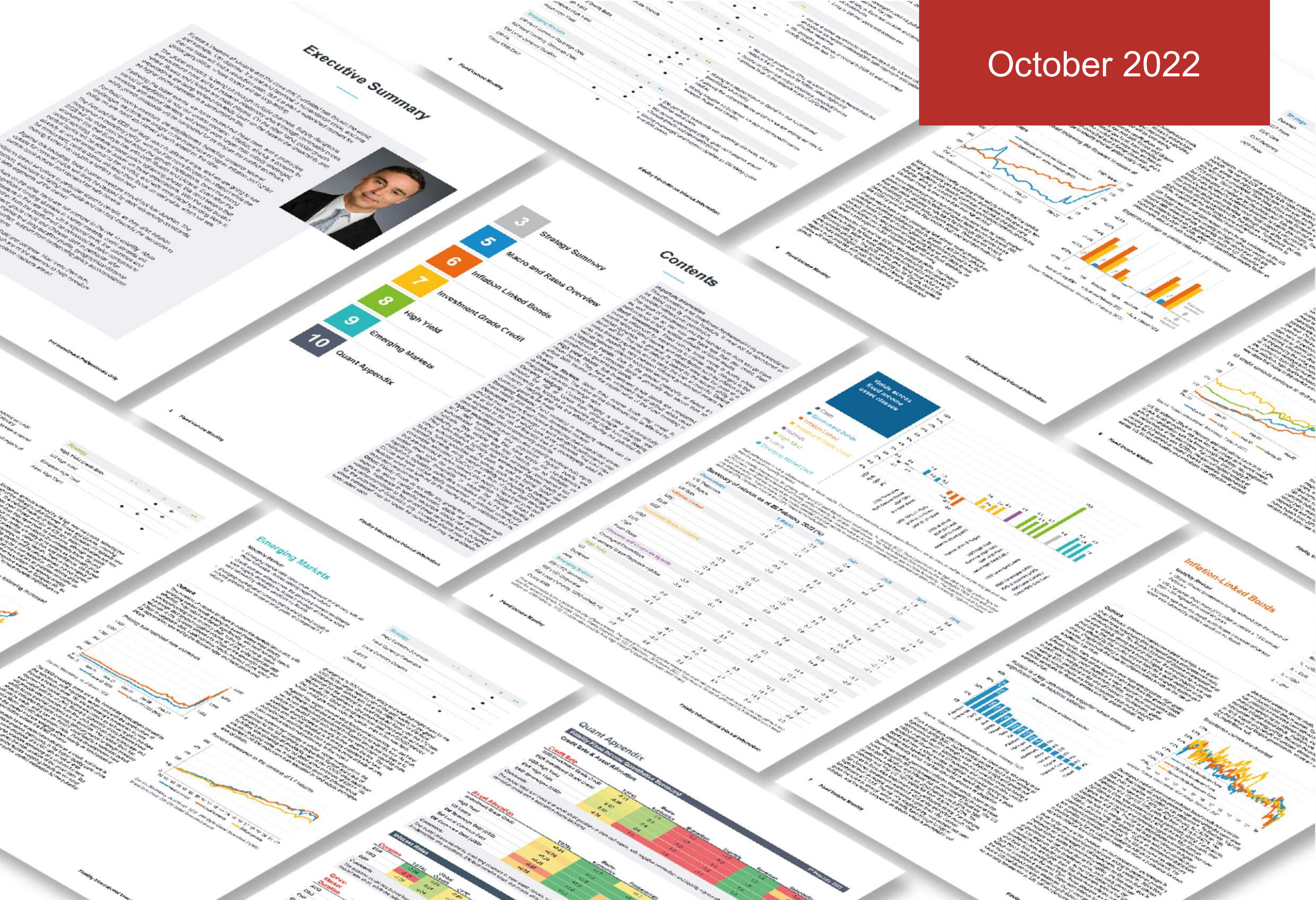

October 2022

Fixed Income Monthly

For Investment Professionals Only

Fidelity INTERNATIONAL

Executive Summary

Central banks continue tightening monetary policy to double down on inflationary pressures. In the case of the US Federal Reserve (Fed), the Bank increased the Federal Funds Rate to a 3% to 3.25% range (up 75bps) at its September meeting, in-line with consensus expectations. As expected, the European Central Bank (ECB) also hiked interest rates to 1.25bps (up 75bps), coupled with a significant upward revision to its inflation outlook.

However, if central banks remain excessively hawkish and over-tighten monetary conditions through a mix of interest rate hikes and quantitative tightening (QT), there is a risk of an inflationary bust, with economies unable to mitigate the risk of a heavy global recession. In September, the Fed’s QT programme ramped up to its maximum level, moving to a new cap of $95 billion per month from $47.5 billion. Some investors are worried that this extra monetary tightening could hurt both the economy and assets prices.

Nevertheless, the high risk of a hard landing makes US and core Europe duration relatively attractive on expectations that in the long run central banks will eventually have to pivot and cut interest rates as inflationary pressures ease and the growth picture continues to deteriorate.

In the US, the prospect of the Fed pivoting has been pushed out to at least March 2023, amid a terminal rate of around 4.6%. However, pricing pressures continue to moderate with the five-year breakeven inflation rate falling to 2.14% at month end, its lowest point since June 2021. Such actions should, in the long run, make the Fed less inclined to carry out impulsive interest-rate rises, which could be a market stabiliser. For Europe, the market continues to project rate hikes into year-end and well into 2023 but we believe this steep hiking path will be hard to implement in practice.

In the near term it is time to remain highly selective. We remain defensive, with continuing exposure to investment grade bonds, where valuations remain relatively attractive. Were the US to head into recession, credit defaults would rise significantly. Yet, the market is yet to reflect these risks, notably in high yield credit. According to our analysis, market implied default rates for the high yield segment currently stands at just 2.7% in the US - roughly what might be expected in a very shallow recession. By contrast, realised defaults peaked at around 14% during the global financial crisis, according to Bank of America Merrill Lynch, with a market implied default rate of above 12%. Prudent credit selection within high yield is therefore essential.

Steve Ellis
Global CIO Fixed Income

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Important Information

This information is for Investment Professionals only and should not be relied upon by private investors. It must not be reproduced or circulated without prior permission.

The value of investments and the income from them can go down as well as up so you may get back less than you invest. Past performance is not a reliable indicator of future results.

Bond investments: Fixed income funds invest in bonds whose price is influenced by movements in interest rates, changes in the credit rating of bond issuers, and other factors such as inflation and market dynamics. In general, as interest rates rise the price of a bond will fall. The risk of default is based on the issuer's ability to make interest payments and to repay the loan at maturity. Default risk may, therefore, vary between different government issuers as well as between different corporate issuers.

Corporate bonds: Due to the greater possibility of default an investment in a corporate bond is generally less secure than an investment in government bonds.

High yield bonds: Sub-investment grade bonds are considered riskier bonds. They have an increased risk of default which could affect both income and the capital value of the Fund investing in them.

Overseas Markets: Some fixed income funds may invest in overseas markets. The value of the investment can be affected by changes in currency exchange rates.

Currency Hedging: Currency hedging is used to substantially reduce the risk of losses from unfavourable exchange rate movements on holdings in currencies that differ from the dealing currency. Hedging also has the effect of limiting the potential for currency gains to be made.

Emerging Markets: Fund investing in emerging markets can be more volatile than other more developed markets.

Derivatives: Some fixed income funds may make use of derivatives and this may result in leverage. In such situations performance may rise or fall more than it would have done otherwise. The fund may be exposed to the risk of financial loss if a counterparty used for derivative instruments subsequently defaults.

Hybrid securities: Hybrid securities typically combine both equity and debt sensitivities and exposures. Hybrid bonds are subordinated instruments that have equity like characteristics. Typically, they include long final maturity (or no limitation on maturity) and have a call schedule increasing reinvestment risk. Their subordination typically lies somewhere between equity and other subordinated debt. As such, as well as typical 'bond' risk factors, hybrid securities also convey such risks as the deferral of interest payments, equity market volatility and illiquidity. Contingent convertible securities ("CoCos") are a form of hybrid debt security that are intended to either convert into equity or have their principal written down upon the occurrence of certain 'triggers' linked to regulatory capital thresholds or where the issuing banking institution's regulatory authorities considers this to be necessary. CoCos will have unique equity conversion or principal write-down features which are tailored to the issuing banking institution and its regulatory requirements.

Other: Fidelity Funds do not offer any guarantee or protection with respect to return, capital preservation, stable net asset value or volatility. Reference to specific securities should not be construed as a recommendation to buy or sell these securities and is included for the purposes of illustration only. Investors should note that the views expressed may no longer be current and may have already been acted upon.

Strategy Summary

The FIXED INCOME MONTHLY provides a forward-looking summary of the medium-term views from the Fidelity Fixed Income team. Our investment approach is multi-strategy, with portfolio managers given clear accountability and fiduciary responsibility for all investment decisions in a portfolio. Given this portfolio manager discretion, there may at times be differences between strategies applied within a fund and the views shared below. We believe in managing portfolios with a mix of active investment strategies, including top-down and bottom-up, such that no single strategy dominates risk in a fund.

Rates	– –	–	=	+	++
Duration				●	
UST Rates				●	
EUR Rates - Core				●	
EUR Rates - Periphery		●			
GBP Rates			●		

Main views

- Remaining overweight US duration with the high risk of a hard landing and expectations of a pivot in 2023 as inflation eases.
- Maintaining overweight stance on European core duration. ECB's window for further hikes is closing fast. Underweight on European peripheral duration with the risk and reward profile still skewed towards the downside.
- Staying neutral on UK duration amid excess volatility.

Inflation	– –	–	=	+	++
Breakeven Inflation		●			
IL – USD		●			
IL – EUR			●		
IL – GBP		●			
IL – JPY			●		

- Maintain underweight in UK and US breakevens with central banks remaining hawkish on monetary policy with inflation in focus.
- We continue to see longer term value in US breakevens.
- Remaining long in US real duration, after having trimmed some of our position on the August CPI release.

Investment Grade Credit	– –	–	=	+	++
Investment Grade Credit Beta			●	←	
USD IG			●		
EUR IG				●	←
GBP IG			●	←	
Asian IG (USD)			●	←	

- Reduced our exposure to Euro IG. However, we remain constructive on the asset class given cheap valuations.
- Maintaining a neutral outlook on US IG.
- We have reduced our outlook on Sterling IG but given very attractive valuations, we are looking to add exposure tactically.
- Lowered our outlook in Asia IG to neutral, as Asia-ex China is experiencing increased macroeconomic headwinds in a risk-off environment.

Financial and Corporate Hybrids	– –	–	=	+	++
Financial and Corporate Hybrids				●	
Contingent Convertibles			→	●	
Investment Grade Corporate Hybrids			●	←	

- Moving to positive on AT1s given significant repricing and value creation.
- Moving to neutral in corporate hybrids given relatively more resilient performance recently.
- Maintain overall positive bias in the asset class on valuation grounds.

High Yield	– –	–	=	+	++
High Yield Credit Beta			●		
US High Yield		→	●		
European High Yield		→	●		
Asian High Yield				●	

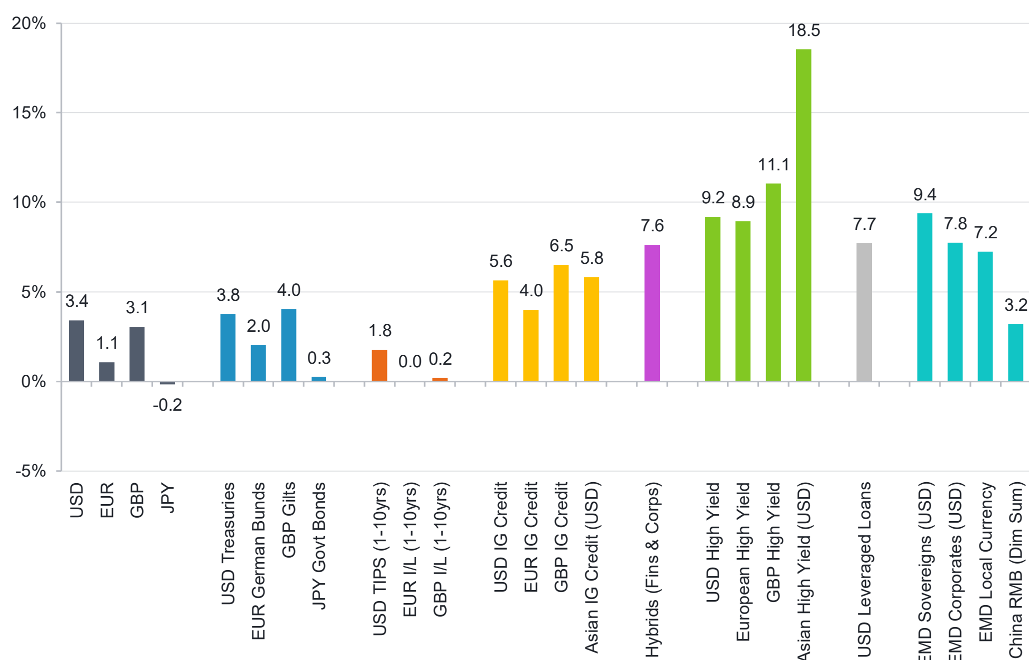
- We remain positive on Asia HY given attractive valuations.
- Changing to neutral on the US HY market with valuations cheapening in September.
- Also changing to neutral on European HY.

Emerging Markets	– –	–	=	+	++
EM Hard Currency Sovereign Debt				●	
EM Hard Currency Corporate Debt				●	
EM Local Currency Duration				●	
EM FX		●			
China RMB Debt			●		

- We remain constructive on EM credit with hard currency sovereign spreads still at multi-year high.
- In EM local rates we continue to be overweight local duration, with a preference for positive real yield markets with disciplined central banks.
- We maintain our cautious stance on EM FX, as the strength of the US dollar remains a key headwind.

Yields across fixed income asset classes

- Cash
- Government Bonds
- Inflation Linked
- Investment Grade Credit
- Hybrids
- High Yield
- Loans
- Emerging Market Debt



Past performance is not a reliable indicator of future results. The value of investments and the income from them can go down as well as up so you may get back less than the amount originally invested.

Source: Fidelity International, Bloomberg, JPM and ICE BofA Merrill Lynch bond indices. 5 October 2022. Shows yield to worst for high yield and EM, yield to 3yrs for USD Loans, real yield for inflation-linked bonds, yield to maturity for all other asset classes. The Yield to Maturity (also known as the Redemption Yield) is the anticipated return on a bond / fund expressed as an annual rate based on price / market value as at date shown, coupon rate and time to maturity. The redemption yield is gross of any charges and tax. Yield to Worst: is the lowest potential yield that can be received on a bond considering all potential call dates prior to maturity. Hybrids universe defined as 50% Corporate Hybrids and 50% Financial Hybrids indices.

Summary of returns as of 30 September 2022 (%)

Government	1 Month	YTD	2021	2020	2019	2018
US Treasuries	-3.8	-13.5	-2.4	8.2	7.0	0.8
EUR Bunds	-4.0	-15.4	-2.6	3.0	3.1	2.4
UK Gilts	-8.5	-26.3	-5.3	8.8	7.3	0.5
Inflation Linked						
USD	-7.3	-14.4	6.0	11.5	8.8	-1.5
EUR	-5.7	-10.0	6.2	3.1	6.0	-1.4
GBP	-7.4	-30.2	3.9	11.3	6.5	-0.3
Investment Grade Corporate						
USD	-5.3	-18.3	-1.0	9.8	14.2	-2.3
EUR	-3.5	-15.1	-1.0	2.6	6.3	-1.1
GBP	-9.5	-24.9	-3.0	8.7	10.8	-2.0
Asian Dollar	-3.6	-12.9	0.0	7.6	11.5	-0.1
Financial and Corporate Hybrids						
Contingent Convertibles	-6.7	-18.3	4.7	6.8	17.6	-3.7
Investment Grade Corporate Hybrids	-5.1	-16.4	1.4	3.8	14.2	-4.6
High Yield						
US	-4.0	-14.6	5.4	6.2	14.4	-2.3
European	-4.1	-18.0	3.3	3.6	13.8	-3.9
Asia	-6.4	-25.9	-6.2	8.4	13.2	-3.3
Emerging Markets						
EM USD Sovereigns	-6.4	-23.9	-1.8	5.3	15.0	-4.3
EM USD Corporates	-3.8	-16.2	0.9	7.1	13.1	-1.6
EM Local Currency (USD unhedged)	-4.9	-18.6	-8.7	2.7	13.5	-6.2
China RMB	-0.1	1.7	3.2	3.7	5.6	5.2

Past performance is not a reliable indicator of future results. The value of investments and the income from them can go down as well as up so you may get back less than the amount originally invested. Source: Fidelity International, ICE, Datastream, 30 September 2022. Total Returns based off JPM and ICE BofA Merrill Lynch bond indices as of 30 September 2022. Custom index used for Asia High Yield (ICE BofA Merrill Lynch Q490 Index).

Macro and Rates Overview

Monthly Review

- The Fed maintained its hawkish rhetoric with the federal funds rate now at 3% to 3.25%, courtesy of a third consecutive rate hike of 75bps to subdue inflation.
- The ECB hiked interest rates to 1.25bps (up 75bps), coupled with a significant upward revision to the inflation outlook.
- The UK government's "mini budget" had a substantial impact on domestic financial markets, with higher terminal interest rate of just under 6% for the Bank of England.

Strategy	– –	–	=	+	++
Duration				●	
UST Rates				●	
EUR Core				●	
EUR Periphery		●			
GBP Rates			●		

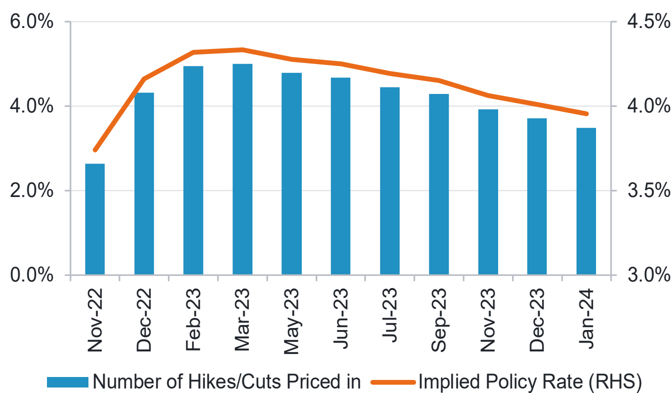
Outlook

The US Federal Reserve maintained its hawkish rhetoric with a third consecutive rate hike of 75bps at its September meeting, in-line with market expectations. The federal funds rate is now at 3% to 3.25%. The updated dot plot shows a larger increase in the end-2023 median rate, to 4.6% from 4.1% and a 'higher for longer' rate trajectory, with the end-2024 median rate at 3.9%.

The Bank's Summary of Economic Projections (SEP) showed weaker growth and higher inflation forecasts, with a higher increase in the unemployment rate now expected to stabilise at 4.4% throughout 2023-2024. More than previously assumed, policymakers now believe that a recession may be necessary to bring inflation back to target. The long-awaited central bank pivot now seems further away. Until we see strong hard data evidence of monetary policy tightening transmitting to the real economy, the Fed will continue its hiking path.

Nevertheless, we remain overweight on duration in the US on expectations that the central bank will have to pivot towards cutting interest rates and support economic growth as inflation starts to cool off, pushing prices up and yields back down. The one-year breakeven inflation rate has fallen below the Fed's 2% target for the first time in two years, largely due to a drop in oil prices. Meanwhile the five-year breakeven inflation rate fell to 2.14% at month end, its lowest point since June 2021. Long-term, these actions should reduce the need for the Bank to continue with impulsive interest-rate hikes, which could be a market stabiliser.

More rate hikes expected before the Fed pivots



Source: Bloomberg, October 2022.

Meanwhile, the European Central Bank (ECB) hiked interest rates to 1.25bps (up 75bps) at its September meeting, in-line with market expectations, coupled with a significant upward revision to the inflation outlook, now at 2.3% in 2024. President Lagarde signalling further tightening to come over the next several meetings, alongside the possibility of rates rising beyond the terminal rate (which is believed to be around 1.5%) if needed.

The ECB continues to aggressively frontload its policy tightening cycle to cushion this winter's energy shock if gets out of control. Further interest rate hikes may continue into year-end and extend well into 2023 but we believe this steep hiking path will be hard to implement in practice. We remain overweight core European duration on the believe that the ECB's window for further hikes is closing fast as the reality of the energy shock and a challenging China outlook take their toll. Eventually the Bank will have to pivot away from its tightening stance to support the European economy as growth continues to deteriorate.

On European peripheral sovereign debt, we remain underweight, with the risk/reward profile still skewed towards the downside amid less ECB support, a worsening economic environment and increasing political risk. The spread between Italian BTPs and German bunds are their widest since March 2020 during the first pandemic lockdown. Recent spread activity was attributable to last month's Italian election, which resulted in nation's right wing political bloc claiming victory with approximately 44% of the vote. A Fratelli d'Italia (FdI)-led government, under Giorgia Meloni is expected to be in place by the end of this month. Investor focus will be on the new prime minister's early decisions, especially around the 2023 budget.

Italian-German spreads continue to widen

Source: Bloomberg, October 2022.

Finally, in the UK, Chancellor Kwasi Kwarteng's long awaited "mini budget" had a substantial impact on domestic financial markets. His unfunded fiscal package pushed gilt yields higher, raised expectations of higher inflation (10-year breakevens at 4.3%) and higher terminal interest rate of just under 6% for the Bank of England. In response, the government relented and has requested that the independent watchdog, the Office for Budget Responsibility (OBR) bring forward the results of its analysis, costing all the policy announcements and providing new numbers for extra borrowing, considering a slowing economy and higher interest rates. We remain neutral on UK duration since the level of volatility makes it impossible to form an informed opinion currently.

Inflation-Linked Bonds

Monthly Review

- Inflation expectations (breakevens) in developed markets fell in September as central banks remained hawkish and oil prices continued to fall.
- The real yield on UK 30-year inflation-linked government bonds rose as high as 2.5% during the month amid a volatile market reaction to the British government's "mini-budget".
- CPI inflation rates were mixed as the US posted headline numbers slightly above consensus for August (8.3% y/y). The UK was slightly below consensus (9.9% y/y) and the Euro Area was in-line with market expectations (9.1% y/y).

Strategy	– –	–	=	+	++
Breakeven Inflation		●			
IL – USD		●			
IL – EUR			●		
IL – GBP		●			
IL – JPY			●		

Outlook

Ten-year breakevens in most developed markets fell over the month as hawkish rhetoric from central banks reassured markets that policymakers' primary focus was inflation. In the US, prices rose by 8.3% year-on-year (y/y) in August, above consensus of 8.1% y/y, representing a slowdown from the prior month. UK prices rose below consensus at 9.9% y/y (vs 10.0% y/y expected), decelerating from July, while Euro Area prices rose in-line with consensus at 9.1% y/y.

Real yields sold off significantly on the month as concerns around the UK spread to global real rates. Ten-year government inflation linked bond yields in the US, UK and Germany rose to 1.7% from 0.7%, 0.0% from -1.5% and 0.0% from -0.8% respectively, as developed market central banks reiterated a hawkish approach to tackling inflation. In the UK, substantial volatility in Gilt markets led some liability driven investing (LDI) investors to sell inflation-linked gilts to meet margin calls, thus exacerbating the rise. The real yield on a 30yr index linked Gilt rose from 0.2% to 2.5% between 22-28 September, wiping out over 20 years' worth of yield falls in a matter of days. Following the Bank of England's announcement to support the long end of the UK curve, 30yr index linked Gilt yields fell 1.5% on the day to finish at 1.0%. This is an astronomical level of volatility and highlights the fragility of financial markets with elevated debt levels.

We continue to hold a short position in breakevens (across the UK and US) at these levels. However, we do think the rise in real yields presents good long-term value and are currently expressing this through a long position in US real duration.

US CPI data surprised to the upside in August, proving the deceleration in the rate of inflation to be slower than expected by markets. Energy prices continued to fall in August, posting a 5% decrease on the month, while prices of clothing, medical care and recreation all saw monthly rises. This led to the core index (ex food and energy prices) also surprising to the upside in August, rising 6.3% y/y vs 6.1% y/y expected.

Shelter costs, which represent approximately 32% of the index, continued to rise in August (0.7% m/m). Housing supply continues to remain low while demand for rentals surged higher. As significant time lags are associated with this, we believe rental data will remain strong, keeping the services component of CPI high. However, expect some softening in headline inflation, especially from the goods channel in the US with supply chain bottlenecks easing and slowing demand habits.

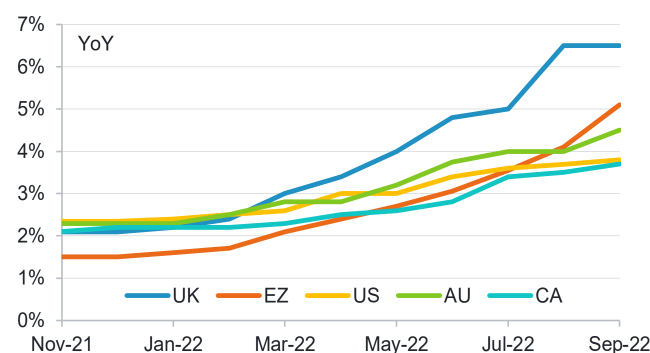
The latest CPI inflation release in the UK saw fuel prices fall 7.1% m/m in August, which led to a below-consensus headline print of 9.9% y/y (vs 10.0% y/y expected). However, UK core inflation (which strips out the effects of food, alcohol, tobacco and energy prices) rose above consensus expectations at 6.3% y/y (vs 6.2% y/y expected). It was the result of elevated pricing power among UK services firms, allowing them to increase the prices of discretionary items, which contributed to the m/m core CPI beat in August.

This represents a transfer of inflationary pressures to non-energy components from energy, raising the risk of further upside surprises in the core rate. Consequently, we believe linkers are a prudent option that can help bolster real returns, providing a hedge against inflation risk. Linkers work such that their principal and coupon are adjusted for inflation. In an inflationary environment where the real value of a nominal bond's fixed coupon payment falls, a linker's coupon rises and thus may outperform a nominal bond. Moreover, over a longer time horizon as linkers mature, investors are likely to receive higher principal payments when inflation has been high as opposed to nominals, where the principal is capped at 100%.

In the Euro Area, inflation rose in-line with consensus at 9.1% in August, the same pace as July. Energy prices surged 38.6% y/y as concerns regarding Russian gas deliveries added to gas and energy price volatility during the month. Fiscal responses to the energy price volatility have been varied in both size and structure as different countries across Europe have divergent amounts of fiscal space. In the UK, one of the fiscal policies set up to help ease the impact of rising energy prices has been a freeze on average household energy bills at £2,500 per year, along with a £400 energy bill rebate due in October. In Germany, a suite of measures has been introduced including one-off payments to pensioners, students and families, an elimination of the renewable energy levy and a decrease in the rate of VAT on natural gas.

The wide range of targeted measures across Europe may increase the volatility of measured inflation - below we show the range of 2023 inflation forecasts across G5 regions. The UK stands out as a clear leader with the highest 2023 inflation forecast, while the Eurozone has surpassed the US since August.

Eurozone inflation is expected to outpace the US in 2023



Source: Fidelity International, Bloomberg, 4 October 2022.

Such trends will exacerbate the uncertainty surrounding the future path of inflation, which will be highly dependent on the effectiveness of government policies going forward. We maintain a neutral position on EUR breakevens given the highly volatility price environment surrounding energy.

Investment Grade Credit

Monthly Review

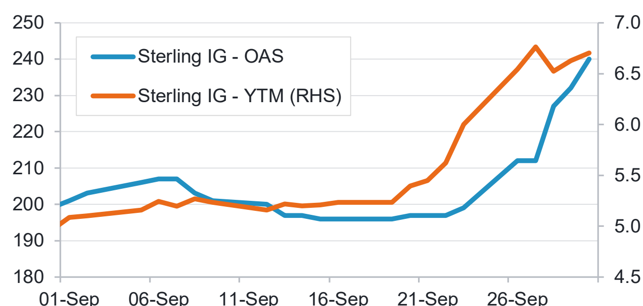
- Investment Grade (IG) credit posted a negative performance in September, predominately driven by high rates volatility on a global level.
- Credit spreads widened in Euro, Sterling and US, mainly driven by elevated macroeconomic concerns and a continuous risk-off environment.
- On balance, we have shifted our outlook to a more neutral stance in Asia and Sterling IG. However, given attractive valuations we continue to add exposure tactically. We have also reduced our outlook on Euro IG to neutral but remain constructive on the asset class.

Strategy	– –	–	=	+	++
IG Credit Beta			●	←	
USD IG			●		
EUR IG				●	←
GBP IG			●	←	
Asian IG (USD)			●	←	

Outlook

Sterling IG posted the highest absolute negative return of 8.6% in September after several unprecedented intraday moves in Gilt yields. Such an extremely large negative monthly return (very uncommon for IG bonds) was predominantly driven by an extensively high level of volatility in Gilt yields across the entire curve. Putting this into context, the 10y yield increased by 120bps over the month, while credit spreads widened by 39bps. Only when the Bank of England (BoE) reacted by announcing temporary purchases of long-dated bonds did the market turmoil ease slightly and the 30y Gilt yield decreased by c110bps in a single day, the biggest fall on record and slightly eased yield levels. Currently, Sterling IG spread moves are determined by broader global factors and it will be critical for the government as well as the BoE to reinstate credibility going forward. We maintain a neutral stance on Sterling IG given the recent widening of credit spreads. However, valuations at current levels appear attractive to tactically add exposure.

Sterling IG - in the eye of the storm

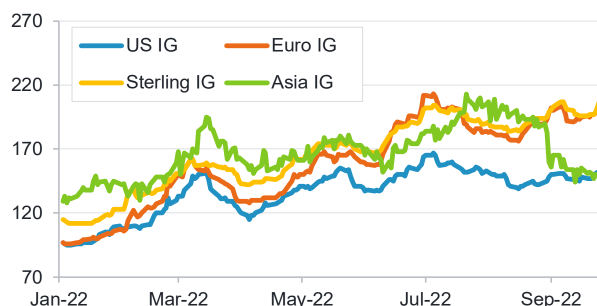


Source: Fidelity International, Bloomberg. 30 September 2022.

Meanwhile, US IG posted a monthly return of -4.3% and US IG credit spreads widened by 7bps. The Fed continues to debate the magnitude of a potential recession. As a result, the asset class continued a risk-off trend and credit spreads subsequently widened. Like other asset classes, the volatility of the rates markets predominantly led to the absolute negative performance of the asset class this month. In September, US financial conditions further tightened and dollar appreciation remains a concern as the Fed takes the global lead in the implementation of hawkish monetary policy, resulting in a further widening in credit spreads. Market volatility has also caused supply to further reduce this month and some of the M&A funding transactions is expected to be postponed to 2023. Valuations in US IG are significantly cheaper, but we acknowledge that the potential for further risk-off events is higher as well. Given this mixed outlook, we remain neutral on US IG credit for now.

Euro IG posted a monthly loss of 3.2% and credit spreads widened by 19bps. Like the other asset classes, Euro rates volatility spilled over and negatively affected Euro IG spreads. The question remains, what comes next for Euro IG? At current valuations, Euro IG spreads are very attractive with only Sterling IG spreads offering greater value on a global basis due to the dislocation over the last weeks. In addition, the German government announced another set of measures to contain the effects caused by high energy prices. They include gas prices capped for households and SMEs, as well as liquidity and capital support for large companies as well as gas importers. More broadly, this reflects the ability of core-Euro governments to introduce further fiscal measures even on a larger scale in case the economic situation deteriorates further. Hence, we have reduced our outlook on Euro IG but continue to keep a constructive outlook on the asset class, given the current attractive valuations.

Global IG credit spreads



Source: Fidelity International, Bloomberg, 30 September 2022.

Asia IG posted similar returns which are largely attributable to the global extreme volatility levels. The asset class posted a loss of 2.8% over September while credit spreads widened by 6bps. However, we continue to keep a constructive outlook on China, amid increasing likelihood of the country reopening, along with other supportive developments. For example, after the steady decline in domestic house prices in recent months, regulators announced that several cities would be allowed to freely adjust their minimum first-home mortgage rates. Furthermore, state-owned banks are instructed to increase funding to developers to ease liquidity shortages.

Meanwhile, we have become more cautious on Asia-ex China on the back of relatively expensive valuations to other IG asset classes as well as further macroeconomic headwinds. Therefore, on a broader level, we have changed our outlook on Asia IG to neutral.

High Yield

Monthly Review

- High Yield (HY) bonds posted negative returns as credit spreads widened over the month.
- Chinese property sector continues to adversely affect Asia HY bonds. Markets are worried about poor liquidity conditions, reports of missed payments and rating downgrades for developers, despite authorities recently rolling out several measures to stabilize the sector.
- Renewed volatility around a global recession and other macroeconomic headwinds, such as COVID-19 related lockdowns in China and the ongoing energy crisis in Europe continues to weigh on HY bonds.

Strategy	– –	–	=	+	++
High Yield Credit Beta			●		
US High Yield		→	●		
European High Yield		→	●		
Asian High Yield				●	

Outlook

Global HY returned -4.3% over the course of September, in local currency terms, while spreads widened by 51bps. These moves were in-line with the broader risk-off tone that surrounded markets as the Fed followed through on its hawkish tone with a third consecutive 75bps rate hike at the September meeting. Particularly alarming to markets was how explicit central banks became about their willingness to maintain restrictive policy, even amidst a growth slowdown. Primary market supply remained muted in one of the seasonally stronger calendar months, supportive of the technical picture as we approach year end. We maintain a neutral stance on Global HY, recognising supportive technicals and increasingly attractive forward return prospects, but at the same time acknowledging global recessionary conditions and the implication for incoming earnings seasons.

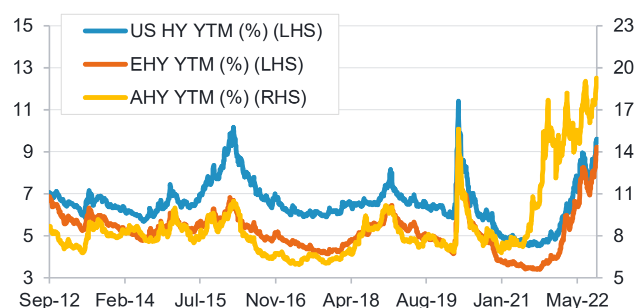
Turning to regional markets, US HY returned -4.0% with spreads widening by 40bps. Within HY, the CCC bucket continued to underperform BBs and Bs, despite the volatility in the rates market, reflecting the poor investor sentiment that surrounds this segment of HY (see diagram below). This can be partially explained by the elevated sensitivity of CCC rated names to idiosyncratic risks. Given the trajectory of global growth and financial conditions in the US, we expect to see more companies, especially further down the ratings spectrum, issuing profit warnings and flagging concerns about the deteriorating operating environment. Technicals are supportive, with HY primary activity still muted as the rates volatility has kept any prospective issuers at bay. Overall, we move to a neutral stance on US HY. We recognise that valuations are attractive with US HY now yielding north of 9%, while the macro backdrop remains challenged with the Fed continuing to tighten. Implied forward return prospects at these levels are relatively healthy in the medium-term.

CCCs have continued to underperform BBs

Source: Fidelity International, Bloomberg. Data as of 30 September 2022. US HY CCC Index: H0A3, US HY BB Index: H0A2.

Returns in European HY totalled -4.2% with spreads widening by 64bps. These moves took place against the backdrop of the ECB going against forward guidance and hiking 75bps in September with inflation continuing to rise to fresh records. Key driver of the record inflation prints in Europe has been the ongoing energy crisis. The inflationary environment coupled with the deteriorating growth outlook suggests that companies will eventually be challenged, giving rise to management guidance revisions. This should be caveated with the fact that the HY asset class is entering the credit cycle with more supportive corporate fundamentals, with a larger amount of BB and secured paper than ever before, relative to similar episodes historically. While the macro-outlook does not paint an inspiring picture, governments offering fiscal stimulus is a support point for consumers and corporates alike. Technicals are neutral with primary activity light. However, we have seen some deals print in this market and while flows have been well absorbed, outflows continue. Valuations, amidst the moves on the month, have cheapened further and as a result we are moving to neutral on European HY. The scale of cheapening is reflected in yields being at multi-year highs (as shown in the corresponding diagram), reflecting that the market has already discounted a lot of bad news. However, we remain wary that vast geopolitical unknowns exist and are a further source of volatility.

Yields at/near multi-year highs across all three regional markets



Source: Fidelity International, Bloomberg. Data as of 30 September 2022. YTM denotes yield to maturity. US HY: ICE BofA US HY Index (H0A0). EHY: ICE BofA Global High Yield European Issuers Constrained Index (HQ0C). AHY: ICE BofA Asian Dollar High Yield Corporate Constrained Index (ACCY).

Asian HY returned -6.7% over the month of September, in local currency terms, with spreads widening by 123bps. We have seen a divergence emerge in performance between more China-sensitive names and those that have a greater sensitivity to ex-China macro developments. The nature of returns for the month can in partially attributable to the region joining the broader risk-off tone that has already occurred in developed markets. Outside of ex-China macro spill-overs, China property policy continues to be a significant driver of the asset class with a more supportive tone being set in recent times. A notable example being the government instructing state-owned banks to support liquidity via increased funding. The upcoming 20th Party Congress will be key in offering greater clarity around the future of the zero-covid policy and can serve as a positive impetus for investor sentiment. With valuations further cheapening we maintain our constructive stance as the rate of defaults continue to be contained outside of Chinese property.

Emerging Markets

Monthly Review

- Emerging market debt came under pressure over the last month with all three sub-assets posting negative returns.
- A rise in US treasury yields and widening of credit spreads weighed on hard currency returns while local currency bonds also suffered due to negative FX returns and a rise in local yields.

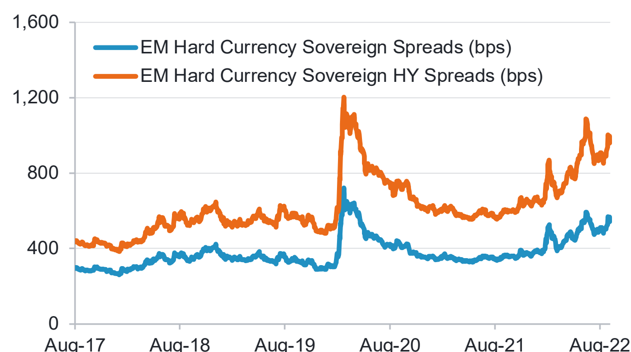
Strategy	– –	–	=	+	++
Hard Currency Sovereign				●	
Hard Currency Corporates				●	
Local Currency Duration				●	
EM FX		●			
China RMB			●		

Outlook

Emerging market debt posted negative returns in September as spreads widened and US Treasury yields rose. Total returns struggled across the board with hard currency sovereigns underperforming both local currency bonds and corporate debt. In the hard currency space, sovereign debt returned -6.4% while EM corporates returned -3.8%. Both sovereign and corporate bond spreads widened during the month by 50bps and 25bps respectively. For both sovereign and corporate USD denominated bonds, rising US Treasury yields proved to be the primary driver of negative performance. Local currency bonds returned -5.1%, driven by both FX depreciation and rising local yields.

The pickup in volatility in September took place against a broader backdrop of market stress following further sizeable policy tightening from the Fed, with escalations in the war in Ukraine further dampening investor sentiment. Amidst the developments, valuations have cheapened, and hard currency sovereign spreads approached multi-year highs once more, especially within high yield. Although we have reduced our credit beta recently, we still maintain a small overweight which reflects this positive risk/reward skew. While the near-term picture is characterised by headwinds, with ongoing tightening of financial conditions and an elevated US dollar, the medium-term fundamental outlook offers greater hope. Policy makers will eventually have to re-prioritise economic activity over price pressures as inflation begins to ease. Such an inflection point would offer a significant reprieve to the asset class and support total returns. Additionally, a key headwind this year has been Chinese policy and its implications for global growth. With the 20th Party Congress taking place later this month, more certainty around Covid and property policy trajectory should support investor sentiment and act as a near term upside catalyst for both the Chinese and global growth outlook.

EM hard currency sovereign spreads approach multi-year highs once more

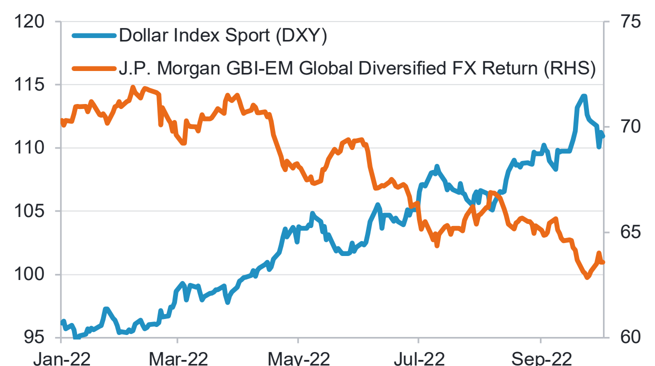


Source: Fidelity International, Bloomberg. Data as of 5 October 2022.

We maintain our underweight stance in EM currencies, with a continued tactical approach to our positioning. US dollar strength has been the key rationale for maintaining the cautious tone on the asset class. The theme of US exceptionalism has been in full swing as reflected in the performance of the US Dollar Index (DXY) relative to EM FX. Being long the dollar has been the consensus trade in FX recently, as it benefits from the advantage versus its peers on growth, real yields while offering defensive qualities in a slower global growth environment. The scale of outperformance has seen the currency reach 20-year highs. The Indian rupee has been a large outperformer this year in the Asian FX complex, but unlike outperforming peers the Singapore dollar and Thai baht, India does not have a current account surplus while its FX reserves have been in rapid decline. Additionally, the currency is exposed to negative real rates relative to the hampered current account profile. We continue to manage our EM FX exposure tactically amidst a few headwinds that could serve to unwind US dollar strength. This includes heavy positioning and FX moves in countries like China and Japan that are characterised by aggressive central bank intervention.

On the local rates side, we continue to be overweight but on a very selective basis in markets with high ex-ante real yields in which central banks are not behind the curve. As we move to a recessionary from a liquidity impaired environment, we remain constructive on local markets, especially Brazil. The latter now has rates at double digits while inflationary pressures are cooling into single digits territory with expectations that they should steeply fall, courtesy of base effect mechanics.

DXY strength relative EM currencies this year



Source: Fidelity International, Bloomberg. Data as of 5 October 2022.

Quant Appendix

Fidelity Fixed Income Quantitative Scorecard

30st September 2022

Credit Beta & Asset Allocation

	TOTAL	Macro-economics*	Sentiment	Valuation	Seasonality
USD Investment Grade Credit	-0.20		-0.5	0.1	0.0
EUR Investment Grade Credit	-0.45		-0.8	0.1	-0.7
USD High Yield	-0.25		-0.7	0.1	0.3
EUR High Yield	-0.23		-0.8	0.1	0.7
EMD Sovereigns (USD)	-0.48	-1.0	-0.6	0.1	-1.0

Comments:

The model maintains its bearish credit positions this month. The short positions marginally increased in size over the month as sentiment continues to sour and seasonality turned weaker, particularly in the case of EMD Sovereigns.

Asset Allocation	TOTAL	Macro-economics	Fundamentals	Sentiment and Liquidity	Valuation and Reversion
Investment Grade Credit	0.07	1.0	0.3	-0.8	0.7
High Yield	0.12	1.0	0.3	-0.7	0.7
US Loans	0.05	1.0	-0.3	-0.7	0.7
EM Sovereign Debt (USD)	0.19	1.0	0.0	-0.8	1.0
EM Local Currency Debt	0.10	1.0	0.0	-1.0	1.0
EM Corporate Debt (USD)	0.12	1.0	1.0	-0.5	0.3

Comments:

The model reduced its risk-on tilt this month with the exceptions of High Yield assets. HY positions are being supported by improving fundamentals and attractive valuation. Sentiment and liquidity have deteriorated across all asset classes dampening the overall long expression of the model.

Interest Rates

Duration	TOTAL	Global Growth	CFTC	CBAI HY	Commodity	Cyc vs. Def	Reversion (Return)	Reversion (Yield)	Global Momentum	Slope	Seasonality
EUR	0.15	0.45	1.06	1.00	1.34	-0.77	2.00	1.99	-2.00	-1.69	-0.63
USD	0.14	0.45	1.06	1.00	1.34	-0.77	2.00	2.00	-2.00	-1.18	-1.22
GBP	0.15	0.45	1.06	1.00	1.34	-0.77	2.00	2.00	-2.00	-2.00	-0.31

Comments:

The model is maintaining its small, long duration positions. As the commodity market cools down, the commodity signal is turning positive on rates assets. This is however being counter-balanced by the global momentum signal as the global bond routs continue, as well as slope getting flatter. The reversion signals remain supportive of duration positions.

Cross-Market Duration	TOTAL (beta-neutral)	`TOTAL	Slope	Real yield	Fair Value	Growth	Inflation	Unemployment
AUD	0.00	-0.14	0.13	0.02	0.04	0.05	-0.66	-0.39
CAD	-0.16	-0.19	-0.30	-0.15	-0.99	0.09	0.32	-0.15
CHF	0.53	0.14	-0.34	1.56	0.35	-0.07	-0.42	-0.27
EUR	-0.20	-0.28	-0.92	-0.75	0.30	0.08	-0.11	-0.30
GBP	-0.10	-0.11	-0.74	-0.39	0.88	0.02	-0.41	-0.02
JPY	0.25	0.36	2.82	-0.31	0.05	-0.34	-0.02	-0.03
NZD	0.00	0.22	0.08	0.65	-0.19	-0.09	0.82	0.05
SEK	-0.35	-0.28	-0.48	-1.20	-0.15	0.23	-0.96	0.88
USD	0.15	0.29	-0.23	0.59	-0.29	0.03	1.44	0.23

Comments: The model maintains its long CHF, JPY and short SEK, GBP trades. The GBP short reduced in size as the improving fair value on gilts more than offset the further inversion of the gilt curve. The model bought SEK vs EUR with the relative steepening in the SEK curve, weakening the bearish stance the model has on the asset.

Quant Appendix explained

Fidelity Fixed Income Quantitative Scorecard

Credit Beta & Asset Allocation

Credit beta:
1. Macroeconomics: global macroeconomic surprises compared to consensus expectations
2. Sentiment: trends in credit spreads and bond market bid-offer spreads
3. Valuation: deviation of spreads from recent averages, expecting reversion to the mean
4. Seasonality: technical indicator driven by historic returns in the corresponding period

TOTAL	1 Macro-economics	2 Sentiment	3 Valuation	4 Seasonality
0.00	0.4	-0.7	0.6	-1.0
0.06	0.4	-0.5	0.6	-1.0
0.00	0.4	-0.7	0.6	-1.0
0.00	0.4	-0.7	0.6	-1.0
-0.13	-1.0	-0.5	0.6	-1.0

Credit Asset Allocation:
1. Macro: Global leading indicators plus qualitative growth and rates/inflation assessment
2. Fundamentals: Aggregated trend of single-company forecasts for leverage, margins and indebtedness
3. Sentiment and Liquidity: trend in bid-offer-spreads, cross-asset-class volatility and spread volatility
4. Valuation and Reversion: deviation of spreads from their historic averages, and risk premium above expected losses given long term average default rates

TOTAL	1 Macro-economics	2 Fundamentals	3 Sentiment and Liquidity	4 Valuation and Reversion
0.08	**0.8**	**0.0**	**0.0**	**0.0**
0.64	**-1.6**	**0.5**	**1.5**	**0.5**
0.75	**-1.1**	**1.5**	**1.6**	**0.0**
0.58	**-0.9**	**1.5**	**1.6**	**-0.5**
-0.34	**-1.5**	**-1.5**	**-0.7**	**1.0**
-0.07	**-1.5**	**-0.3**	**-0.1**	**0.5**
-0.09	**-1.3**	**-0.5**	**-0.1**	**0.5**

Directional Duration:
1. Growth forecast momentum: lower forecasts are dovish, lead to lower rates.
2. CFTC: signal tracking the Treasury futures contract holdings of institutional investors.
3. CBAI HY: indicator of stress in the HY credit market by evaluating bid-ask spread dispersion in the index
4. Commodities momentum: a proxy for state of the economic cycle
5. Cyclical stocks outperformance: a proxy for economic optimism
6. Reversion (Return): deviation of price from their average historic value, expecting reversion to the mean
7. Reversion (Yield): deviation of yield from their average historic value, expecting reversion to the mean
8. Momentum: measures large moves in a single direction, taking advantage of autocorrelation of flows and returns
9. Slope of the yield curve: steep curves earn a higher risk premium
10. Seasonality: technical indicator driven by historic returns in the corresponding period

1 Global Growth	2 CFTC	3 CBAI HY	4 Commodity	5 Cyc vs. Def	6 Reversion (Return)	7 Reversion (Yield)	8 Global Momentum	9 Slope	10 Seasonality
0.46	1.42	0.43	-0.10	0.17	2.00	1.79	-1.84	-0.95	0.51
0.46	1.42	0.43	-0.10	0.17	2.00	1.28	-1.84	-0.69	0.14
0.46	1.42	0.43	-0.10	0.17	2.00	1.67	-1.84	0.09	0.07

Cross Market Duration:
1. Slope of the yield curve: steep curves earn a higher risk premium
2. Real yield: yields adjusted for inflation, tend to revert to the mean
3. Fair value: forward yields adjusted for GDP trend, tend to revert to the mean
4. Growth forecast momentum: lower forecasts dovish, lead to lower rates
5. Inflation forecast momentum: lower forecasts dovish, lead to lower rates
6. Unemployment forecast momentum: lower forecasts are hawkish, lead to higher rates

1 Slope	2 Real yield	3 Forward yield	4 Growth	5 Inflation	6 Unemployment
-0.2	-0.1	-0.4	-1.1	-0.4	0.0
-1.3	0.5	0.4	0.4	-0.3	-0.2
1.0	0.1	0.5	0.4	-0.1	-0.5
0.8	-0.3	-0.1	0.6	-0.3	0.0
-0.6	0.4	0.3	-0.7	1.1	0.2
0.8	0.1	-0.2	0.3	-0.4	0.0
0.6	-0.6	-1.1	0.1	-0.1	0.1
0.3	-0.5	-0.4	0.5	0.5	0.1
-1.3	0.4	1.1	-0.6	0.0	0.2

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